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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1945

No. 56

KIRBY PETROLEUM COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT
OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 9, 1945.

CERTIORARI GRANTED MAY 21, 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 56

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vs.

COMMISSIONER OF INTERNAL REVENUE

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OF APPEALS FOR THE FIFTH CIRCUIT

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., JULY 27, 1945.

[fol. a]

[Caption omitted]

[fols. 1-2]

IN THE TAX COURT OF THE UNITED STATES

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appearances:

For Taxpayer: H. P. Haschke, C. P. A., Homer L. Bruce, Esq.

For Comm'r: L. E. Keir, Esq.

DOCKET ENTRIES

1943

May 3. Petition received and filed. Taxpayer notified. Fee paid.

May 4. Copy of petition served on General Counsel.

Jun. 4. Answer filed by General Counsel.

Jun. 4. Request for hearing in Houston, Texas, filed by General Counsel.

Jun. 8. Notice issued placing proceeding on Houston, Texas calendar. Answer and request served.

Sep. 16. Hearing set October 25, 1943—Galveston, Texas.

Oct. 26. Hearing had before Judge Black, on the merits. Submitted. Stipulation of facts and exhibits attached thereto filed. Briefs due 1-2-44. No replies.

Nov. 16. Notice of appearance of Homer L. Bruce filed by taxpayer.

Nov. 30. Transcript of hearing 10-26-43 filed.

Dec. 13. Brief filed by taxpayer.

[fol. 3] Dec. 30. Opinion rendered—Judge Black, Div. 15. Decision will be entered under Rule 50. 12-30-43. Copy served.

Dec. 31. Brief filed by General Counsel. Served 1-3-44.

1944.

Jan. 3. Copy of brief served on General Counsel.

Feb. 1. Computation of deficiency filed by General Counsel.

Feb. 3. Consent to settlement filed by taxpayer.

Feb. 5. Decision entered. Eugene Black, Judge. Div. 15.

Apr. 21. Petition for review by U. S. Circuit Court of Appeals, 5th Circuit, with assignments of error filed by General Counsel.

May 2. Proof of service filed by General Counsel. (2)

Jun. 9. Praecipe for record filed by General Counsel.

[fol. 4] THE TAX COURT OF THE UNITED STATES

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION—Filed May 3, 1943

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols IRA :90D-H, dated February 5, 1943) and as a basis for this proceeding alleges as follows:

(1) That the Petitioner is a Delaware corporation with its principal office in the City of Houston, State of Texas.

(2) The notice of deficiency (a copy of which is attached hereto and marked Exhibit A) purports to have been mailed to Petitioner under date of February 5, 1943.

(3) The taxes in controversy are income taxes of the Petitioner for the taxable year ended December 31, 1940 in the amount of \$2,120.44.

(4) In the determination of income tax set forth in said deficiency notice, the Commissioner committed the following error:

(A) In disallowing as a deduction in the taxable year ended December 31, 1940 the sum of \$7,211.52 representing statutory 27½% depletion claimed by Petitioner on the amount received by it (\$26,223.70) as its share of the net

profits from operations by the lessee, Humble Oil & Refining Company, of the Anna Higgins Tract #40 in Chambers County, Texas.

(5) The facts upon which petitioner relies as a basis in this proceeding are as follows:

(A)(1) On December 6, 1923, petitioner acquired fee simple title to the tract of land in Chambers County, Texas, known as Anna Higgins Tract #40. This tract was acquired by deed from Old River Company to petitioner and contained 49.5 acres, described by metes and bounds in the deed as recorded in the Deed Records of Chambers County, Texas. However, one-eighth of the mineral interest in said tract of land was owned by Anna Higgins, wife of Patillo Higgins, former fee owner, and was never acquired by petitioner.

(A)(2) On September 29, 1927, petitioner executed an oil and gas lease to Humble Oil & Refining Company and Marland Oil Co. of Texas whereby the Anna Higgins Tract #40, together with another tract of land out of the Jergins Survey in Chambers County, Texas, was leased for a primary term of five years. (The tract of land out of the Jergins Survey is not involved in this petition as no production has been obtained therefrom under this lease although it is validated by the production of oil from the Anna Higgins Tract #40.)

(A)(3) As consideration for the execution of such lease, petitioner received a cash bonus of \$35,000.00 and an additional bonus measured by and consisting of twenty per cent (20%) of the net money profits derived by lessees from operations under and by virtue of said lease.

(A)(4) This additional bonus to be received by petitioner was provided for and specifically described and defined by a supplemental agreement entered into by petitioner and lessees simultaneously with the execution of the lease instrument on September 29, 1927. This supplemental agreement is made a part of such lease by specific reference thereto in the supplemental agreement and such agreement states that the parties to said lease have [fol. 6] agreed that petitioner shall be entitled to receive twenty per cent (20%) of the net money profits derived by lessees from operations under said lease. This supplemental agreement describes and defines the calculation

and determination and the method of payment of such share of the profits to petitioner.

(A) (5) By the terms of such lease, lessee is to pay a one-sixth royalty on oil and gas produced and saved from said land, the same to be delivered at the wells or to the credit of lessor in the pipe line to which the wells may be connected.

(A) (6) Petitioner therefore reserved a one-sixth oil and gas royalty by such lease. However, after deducting therefrom the one-eighth royalty payable to Anna Higgins, which mineral interest petitioner never acquired, petitioner retained a net one-twenty-fourth oil and gas royalty interest in such tract of land under and by virtue of said lease. Since petitioner is the original lessor, it therefore retained an economic interest in the oil and gas in place under the Anna Higgins Tract #40.

(A) (7) Lessee commenced the drilling of a well on the Anna Higgins Tract #40 in August 1932 prior to the termination of the primary term of the lease and obtained production of oil therefrom. By December 1934 lessee had recovered its cost of development from proceeds of the sale of oil and in March 1935, petitioner received the first payment of its profits from the operation of the lease as provided in the supplemental agreement. Petitioner has received such payments of profits each year from 1935 through 1940 and for the year 1940, the amount of such profits payments received was \$26,223.70.

(A) (8) Under the terms of the lease and supplemental agreement, the profits payments represent additional cash bonus paid by the lessee in consideration for the execution of the lease by the lessor. There is no difference between the payments received by petitioner as its share of lessee's [fol. 7] profits from the operations of the lease and the cash bonus received in 1927. The provision in said supplemental agreement that the payment was to be a percentage of the lessee's income from operations of the lease, represents simply a method or means of determining the amount of the bonus to be received by petitioner.

(A) (9) Lessee, Humble Oil & Refining Company, is required by the Commissioner of Internal Revenue to capitalize for income tax purposes, the profits payments made

to petitioner as a cost of the lease, thus indicating that these payments constitute a bonus paid to the lessor by the lessee as consideration for the execution of the lease.

(A)(10) Respondent has allowed for 1940 depletion on the one-twenty-fourth oil and gas royalty interest payments received by petitioner in that year.

(A)(11) Under the provisions of Regulations 103, Section 19.23(m)-10(d), the owner of an economic interest in oil and gas wells may take as a depletion deduction, in respect of any bonus or advanced royalty from the property for the taxable year, $27\frac{1}{2}\%$ of the amount thereof.

(A)(12) Petitioner therefore is entitled to deduct in 1940, allowable statutory depletion of $27\frac{1}{2}\%$ (\$7,211.52) on the profits payments received in 1940, amounting to \$26,223.70, as these payments constitute bonus received for the execution of a lease, by which lease taxpayer, being the fee owner, retained a net one-twenty-fourth royalty interest in the land leased which constitutes an economic interest in the oil and gas under the tract of land leased.

Wherefore, the petitioner prays that this Court may hear and determine its appeal;

Petitioner further prays that the Court may determine that:

(1) Petitioner owes no income tax for the year 1940 in excess of \$930.55.

[fol. 8] (2) That the Court may grant such other and further relief as the nature of the case may warrant.

Kirby Petroleum Company, by (Sgd.) George Sawtelle, President (Petitioner).

Dated: Houston, Texas, April 30, 1943.

(Sgd.) H. P. Haschke, Counsel, % Peat, Marwick, Mitchell & Co., 703 National Bank Bldg., Houston, Texas.

Duly sworn to by George Sawtelle. Jurat omitted in printing.

[fol. 9]

EXHIBIT "A" TO PETITION

Treasury Department

Internal Revenue Service

Dallas, Tex.

Dallas
IRA:90D-H.

Kirby Petroleum Company, 1121 Commerce Building, Houston, Texas

SIRS:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1940 discloses a deficiency of \$2,120.44, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 422 Federal Building, Dallas, Texas, for the attention of C:RLP. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest [fol. 10] period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner; by
(Sgd.) B. W. Wilde, Internal Revenue Agent in Charge.

Enclosures: Statement Form of waiver.

Copy

STATEMENT

Dallas
IRA :90D-H.

Kirby Petroleum Company,
1121 Commerce Building,
Houston, Texas

Tax Liability for the Taxable Year Ended December 31,
1940

	Liability	Assessed	Deficiency
Income Tax	\$2,120.44	\$ None	\$2,120.44

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated April 1, 1942; to your protest executed June 5, 1942; and to the statements made at the conferences held on July 6, 1942 and November 24, 1942.

If you do not acquiesce in all of the adjustments making up the deficiency indicated, but desire to stop the accumulation of interest on that part of the deficiency resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of the deficiency you desire to have assessed at once. The execution of the form for the agreed portion of the deficiency will not deprive you of your right to petition The Tax Court of the United States for a redetermination of the deficiency.

Copies of this letter and statement have been mailed to your representatives, Mr. H. P. Haschke, State National Bank Building, Houston, Texas, and Mr. Frank C. Taylor, 220 Construction Building, Dallas, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

Adjustments to Net Income

Net income as disclosed by return (Loss) (\$9,208.31)

Unallowable deductions and additional income:

(a) Depreciation	\$4,659.13	
(b) Depletion	8,094.67	
(c) Loss on property exchanged	46.88	
(d) Capital stock tax	230.35	
(e) Abandoned equipment	9,528.41	22,559.44

Net income adjusted \$13,351.13

Explanation of Adjustments

(a) This item represents excessive depreciation deducted on transportation equipment, furniture and fixtures, and well equipment, as shown below:

Depreciation	Deducted	Allowed	Decease
Furniture and Fixtures	\$515.20	\$185.92	\$329.28
Transportation equipment	1,387.09	1,360.96	26.13
Lease and well equipment	30,456.53	26,152.81	4,303.72
Totals	\$32,358.82	\$27,699.69	\$4,659.13

[fol. 12]

Determined allowable 27,599.69

Disallowed \$4,659.13

(b) This item represents depletion adjustment as follows:

	Depletion	
	Reported	Corrected
Operating Leaseholds	\$88,162.96	\$87,381.14
Producing royalties	38,821.89	31,509.04
	\$126,984.85	\$118,890.18
	118,890.18	
Total adjustment	\$8,094.67	

It is held that no depletion is allowable in respect to the amount \$26,223.70 received by you as your share of your lessee's net profits from operations.

(c) This item is represented by loss claimed on exchange of two typewriters for new typewriters in taxable year. Such apparent losses are not deductible but should be added to the bases of the new machines.

(d) This item represents excessive deduction for Federal capital stock tax as shown below.

Capital stock tax as deducted	\$3,530.35
Capital stock tax allowable	3,300.00
Adjustment	<u>\$230.35</u>

You have been allowed capital stock tax as accrued inasmuch as your records are kept on the accrual basis.

(e) It is held that no loss was sustained upon retirement of well equipment on the Carrie Baker lease.

[fol. 13]

Computation of Tax

Income Tax	
Net income	\$13,351.13
Adjusted net income	\$13,351.13
Amount subject to income tax	\$13,351.13
13.5% of \$5,000.00 (Not in excess of \$5,000)	\$675.00
15% of \$8,351.13 (Over \$5,000 to \$13,351.13)	1,252.67
Total	<u>\$1,927.67</u>
Defense tax (10% of \$1,927.67)	192.77
Correct income tax liability	<u>\$2,120.44</u>
Income tax assessed, account #852143	None
Deficiency of income tax	<u>\$2,120.44</u>

[fol. 14] THE TAX COURT OF THE UNITED STATES

[Title omitted]

ANSWER—Filed June 4, 1943

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

(1)-(3). Admits the allegations contained in paragraphs (1) to (3), inclusive, of the petition.

(4) (A). Denies that the Commissioner erred as alleged in subparagraph (A) of paragraph (4) of the petition.

(5) (A) (1)-(9). Denies the allegations set forth in subparagraphs (A) (1) to (A) (9), inclusive, of paragraph (5) of the petition.

(A) (10). Admits that the Commissioner allowed for 1940 depletion on the one-twenty-fourth oil and gas royalty interest payments received by petitioner in that year, as alleged in subparagraph (A) (10) of paragraph (5) of the petition.

(A) (11)-(12). Denies the allegations contained in subparagraphs (A) (11) and (A) (12) of paragraph (5) of the petition.

[fol. 15] Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

(Signed) J. P. Wenchel FBS.

J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, Division Counsel;
Loyal E. Keir, Special Attorney, Bureau of Internal Revenue.

LEK:MJH.

[fol. 16] THE TAX COURT OF THE UNITED STATES

Docket No. 150

KIRBY PETROLEUM COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Promulgated December 30, 1943

Petitioner was the fee simple owner of two tracts of land and leased them to oil companies for exploration

and production. In the lease petitioner reserved to itself a one-sixth oil royalty and in a contemporaneous written agreement entered into between petitioner and the lessees it was agreed that in addition to the one-sixth oil royalty petitioner should be entitled to receive twenty percent of the net profits realized by the lessees from their operations of the lease. The Commissioner has allowed petitioner percentage depletion of its one-sixth oil royalty received but has disallowed depletion on the amount paid petitioner as twenty percent net profits from the operation of the lease. *Held*, petitioner is entitled to percentage depletion on the twenty percent profits paid it by reason of its reserved interest in the oil in place. *W. S. Green*, 26 B.T.A. 1017 and *Marrs McLean*, 41 B. T. A. 565, follow. *Helvering v. Elbe Oil Development Co.* 303 U. S. 372, distinguished. *Homer L. Bruce, Esq.*, for the petitioner.
Loyal E. Keir, Esq., for the respondent.

OPINION

BLACK, Judge:

The Commissioner has determined a deficiency in petitioner's income tax for the year 1940 of \$2,120.44.

The deficiency results from five adjustments to net income as disclosed by petitioner in its return for the year 1940. The only one of these adjustments which petitioner contests is adjustment (a). Petitioner concedes the correctness of the other four adjustments made by the Commissioner and [fol. 17] states in its brief that it has paid the additional tax due to these items. As to adjustment (a) the petitioner alleges that the Commissioner erred:

In disallowing as a deduction in the taxable year ended December 31, 1940 the sum of \$7,211.52 representing statutory 27½% depletion claimed by Petitioner on the amount received by it (\$26,223.70) as its share of the net profits from operations by the lessee, Humble Oil & Refining Company, of the Anna Higgins Tract #40 in Chambers County, Texas.

The facts have been stipulated and as stipulated are adopted as our findings of fact. Only a brief resume of these facts is necessary to an understanding of the issue which we have to decide.

Petitioner is a Delaware corporation with its principal office in Houston, Texas.

The income tax return of petitioner for the taxable year 1940 was filed with the Collector of Internal Revenue for the First District of Texas at Austin, Texas.

Prior to September 27, 1927, petitioner was the owner of the fee simple title to two tracts of land situated in Chambers County, Texas, aggregating slightly more than 100 acres, except as to one of the tracts Anna Higgins owned $\frac{1}{8}$ of the mineral interest in said tract and that interest was never acquired by petitioner.

On September 29, 1927, petitioner leased the two tracts of land in question to Humble Oil & Refining Company, sometimes hereafter referred to as Humble, and Marland Oil Company of Texas, sometimes hereafter referred to as Marland, for oil and gas exploration and production. Petitioner in said lease retained a royalty of $\frac{1}{8}$ of all oil produced and saved and varying royalties on other mineral.

Contemporaneously with the execution and delivery of the lease, petitioner and the lessees executed an agreement under which petitioner was entitled to receive 20 percent [fol. 18] of the net profits realized by the lessees from their operations under and by virtue of the lease. The agreement in that respect reads as follows:

Second Party, [meaning Kirby Petroleum Company] subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty percent (20%) of the net money profits realized by First Party from its operations under and by virtue of the lease referred to above. The net money profits in which Second Party shall participate under the terms hereof, shall be calculated and determined and be payable as hereinafter provided.

Section III and V of the agreement provide how the net profits from the operation of the lease shall be calculated and how petitioner's share of such net profits shall be paid over to it. These provisions need not be set out here as there is no controversy about them.

The lessees drilled and completed the first well in 1932 and have produced oil from the lease continuously thereafter. In 1935 petitioner received its first payment under the profits agreement from the operation of the leased premises and received such payment for each year from

1935 through 1940. The amount received under the profits agreement for 1940 was \$26,223.70. In its return for 1940 petitioner deducted for depletion 27½ percent of this amount. The question which we have to decide is whether petitioner is entitled under the applicable statute to the percentage depletion which it has thus deducted. The applicable statute is section 114 (b) (3), I. R. C., which is printed in the margin.¹

[fol. 19] Petitioner in support of its contention relies principally upon our decision in *W. S. Green*, 26 B. T. A. 1017. In that case we held that the taxpayer, a lessor of oil property, was entitled to depletion on sums received on his one-third interest in the profits from the lessee's operations in addition to depletion on his 3/32 royalty interest. There can be no doubt that our decision in the *Green* case is in point to a decision of the issue in the instant case and should be followed unless decisions by the Supreme Court of the United States have in effect overruled it. The Commissioner contends that such is the case and cite in support of his contention *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372; *Anderson v. Helvering*, 310 U. S. 404.

Petitioner contends that these cases are clearly distinguishable on their facts from the instant case. Petitioner points out that in the *O'Donnell* case the taxpayer owned part of the stock of San Gabriel Petroleum Company, which he sold to the Petroleum Midway Company, Ltd. As consideration for the payment of this stock the Midway Company agreed to acquire the properties of the San Gabriel Company and to pay the taxpayer 1/3 of the net profits from the operation of those properties. The petitioner

¹ (3) Percentage depletion for oil and gas wells. In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph. points out that through this arrangement the taxpayer ac-

quired no interest in the oil and gas in place, and inasmuch as he owned none before hand the Supreme Court properly denied any depletion on the payments made to him out of the profits derived by the Midway Company from the operation of the San Gabriel oil and gas properties.

In distinguishing *Helvering v. Elbe Oil Land Development Co.*, *supra*, the petitioner points out that the taxpayer in that case sold absolutely all of its interest in certain oil and gas properties for \$350,000 in cash, \$1,650,000 additional cash payable over a period of four years and for the additional agreement by the purchaser to pay the taxpayer one-third of the net profits resulting from the operation of the properties after the purchaser had re-[fol. 20] covered all of its expenditures in the acquisition, development and operation of the properties. The agreement specifically provided that it was the intention of the parties that the full ownership, possession, and control of the properties should be vested in the purchaser and that the taxpayer should have no interest whatsoever in the properties. Petitioner points out that the Supreme Court under such circumstances properly denied to Elbe Oil Land Development Company depletion on the payments received under the contract because the payments were simply payments to the taxpayer of a part of the purchase price of property which it had sold and that the taxpayer was entitled to no percentage depletion on these payments because it had retained no capital investment in the properties. Petitioner distinguishes *Anderson v. Helvering*, *supra*, on like grounds.

In the instant case petitioner lays emphasis on the fact that it was the owner in fee simple of two tracts of land and leased them to Humble and to Marland for development and operation and that in granting the lease it retained for itself a $\frac{1}{8}$ oil royalty and 20 percent net profits from the operation of the lease each year. Respondent has not disputed petitioner's right to percentage depletion on the $\frac{1}{8}$ oil royalty reserved in the lease but does dispute petitioner's right to percentage depletion on the \$26,223.70 net profits which petitioner received in 1940 from operations.

Petitioner contends that it is as much entitled to depletion on this \$26,223.70 as it is on the receipts from its $\frac{1}{8}$ oil royalty and distinguishes its situation from that which existed in *Helvering v. O'Donnell*, *supra*, and *Helvering v. Elbe Oil Land Development Co.*, *supra*, and *Anderson v.*

Helvering, supra, on the grounds which we have already stated. We agree with petitioner in the distinction which it draws.

Although petitioner does not cite in its brief our decision in *Marrs McLean*, 41 B. T. A. 565, affd. on another ground 120 Fed. (2d) 942, we think our decision in that case concerning the Gray lease, issue No. 2, supports petitioner's [fol. 21] contention here. In speaking of the Gray lease in our opinion in the *McLean* case, we said:

* * * It purported to convey only three-fourths of McLean's interest and provided: "While this contract covers only an undivided three-fourths ($\frac{3}{4}$) interest in the two assigned tracts, the Gulf Refining Company of Louisiana shall, as and while it holds hereunder, have exclusive operating rights in such two assigned tracts and exclusive control and management of operation."

After stating these facts we said:

* * * Thus, McLean retained an economic interest in a part of the oil in place and the payments which he was to receive were secured by that interest and were not dependent alone upon the contractual obligation of Gulf. Although the payments were measured by one-fourth of the net profits realized from the operation of the properties, and although there is no statement in the contract that those payments are to be made from any portion of the oil, nevertheless, this contract did not effect a sale of McLean's interest. It is unlike the contracts in the *Elba* and *Blankenship* cases, which purported to convey all of the interest of the assignors. It is more like the contracts in the *Palmer*, *Perkins*, and *Harmel* cases. Consequently, we hold that the petitioners are entitled to depletion in connection with the Gray leases.

What is petitioner's "gross income from the property" in 1940 within the meaning of section 114(b) (3) and which it must include in its gross income for income tax purposes? We think it is clearly the proceeds from the $\frac{1}{8}$ royalty which petitioner retained in the lease and the 20 percent annual profits which it received from the operation of the lease under the contemporaneous agreement amounting in 1940 to \$26,223.70. If this view is correct, then petitioner

is entitled to percentage depletion on the amounts received from its part of the profits as much as from the amounts [fol. 22] received from its retained $\frac{1}{8}$ oil royalty. And in filing their returns the lessees, Humble and Marland, would not include in their gross income from the property for the purpose of taking percentage depletion, the $\frac{1}{8}$ oil royalty plus \$26,223.70 profits paid petitioner in 1940. That is the substance of what we held as to the Gray lease in the *McLean* case. On that point we said:

• • • The term "gross income from the property" means the gross income from the property received by the particular taxpayer claiming a deduction for depletion and is synonymous with the amount to be included in the taxpayer's gross income under section 22. *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312. The gross income from the property, from the standpoint of the McLeans, was the amount which Gulf paid them. They do not even suggest the propriety of including any greater amount in their gross income under section 22. No doubt the amount which Gulf paid them would be considered a rent or royalty paid by that taxpayer in respect of the property in computing its deduction under section 114(b)(3). • • •

For the reasons stated and discussed above we sustain petitioner on the only issue submitted to us for decision.

Decision will be entered under Rule 50.

[fol. 23] THE TAX COURT OF THE UNITED STATES, WASHINGTON.

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION

Pursuant to the Court's opinion, promulgated December 30, 1943, the respondent having filed a recomputation

of tax on February 1, 1944, and the petitioner having filed an acquiescence in said recomputation on February 3, 1944, it is

Ordered and Decided: That there is a deficiency in income tax of \$930.53 for the calendar year 1940.

Enter:

(Signed) Eugene Black, Judge.

Entered Feb. 5, 1944.

[fol. 24] IN UNITED STATES CIRCUIT COURT OF APPEALS FOR
THE FIFTH CIRCUIT

[Title omitted]

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR—Filed
April 21, 1944

To the Honorable Judges of the United States Circuit Court
of Appeals for the Fifth Circuit:

Now Comes Joseph D. Nunan, Jr., Commissioner of Internal Revenue, by and through his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and Bernard D. Daniels, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I

That he is the duly appointed, qualified and acting Commissioner of Internal Revenue, appointed and holding office by virtue of the laws of the United States; that the respondent on review, Kirby Petroleum Company (hereinafter referred to as the taxpayer) is a corporation organized and existing under the laws of the State of Delaware and having its principal office in Houston, Texas. The taxpayer filed its Federal income, excess profits and defense tax return for the calendar year 1940, the taxable year here involved, with the Collector of Internal Revenue for the [fol. 25] First Texas District, which office is located in the City of Austin, Texas, and within the judicial Circuit of the United States Circuit Court of Appeals for the Fifth Circuit.

The Commissioner filed this petition pursuant to the provisions of Section 1141 and 1142 of the Internal Revenue Code.

II

Prior Proceedings

On February 5, 1943 the Commissioner of Internal Revenue determined that there is a deficiency in income tax against the taxpayer for the year 1940 in the sum of \$2,120.44, and sent to the taxpayer, by registered mail, a notice of said deficiency in accordance with the provisions of the existing Internal Revenue Laws. Thereafter, and on May 3, 1943, the taxpayer filed an appeal from the said determination of the Commissioner with The Tax Court of the United States.

The case was duly tried and submitted to The Tax Court of the United States and on December 30, 1943, The Tax Court of the United States promulgated its opinion (2 T. C. 1258), pursuant to which opinion, decision was entered on February 5, 1944, wherein and whereby it was ordered and decided "that there is a deficiency in income tax of \$930.53 for the calendar year 1940."

III

Nature of Controversy

Prior to September 27, 1927 the taxpayer was the owner of fee simple title to two tracts of land except, as to one of the tracts, Anna Higgins owned one-eighth of the mineral interests therein. On September 29, 1927 the taxpayer leased said two tracts of land to Humble Oil and Refining Company and Marland Oil Company of Texas for oil and gas exploration and production. In the said lease the taxpayer reserved to itself a one-sixth oil royalty. In a contemporaneous written agreement entered into between [fol. 26] the taxpayer and the lessees it was agreed that in addition to the one-sixth oil royalties the taxpayer should also be entitled to receive 20 percent of the net profits realized by the lessees from their operation of the lease.

During the calendar year 1940, the taxpayer received from the lessees its one-sixth royalty payment, pursuant to the terms of the lease and \$26,223.70, representing 20 per cent of the net profits realized by the lessees from their operation of the lease, pursuant to the contemporaneous

written agreement between the taxpayer and the lessees. In computing its net taxable income for the year 1940, the taxpayer deducted for depletion $27\frac{1}{2}$ percent of the royalty payments received and also $27\frac{1}{2}$ percent of the \$26,223.70.

In his determination of the deficiency due for the year 1940, the Commissioner disallowed several deductions claimed by the taxpayer on its return filed for that year. Included in the deductions disallowed by the Commissioner was an item of \$7,211.52 representing statutory $27\frac{1}{2}$ percent depletion claimed by the taxpayer on the amount received by it (\$26,223.70) as its share of the net profits from operation of the lease by the lessees. The taxpayer, in its petition filed with The Tax Court of the United States, alleges that the Commissioner erred in disallowing as a deduction the item of \$7,211.52 (statutory $27\frac{1}{2}$ percent depletion on \$26,223.70), but did not contest the other adjustments made by the Commissioner in his determination of the deficiency for the year 1940. The Tax Court decided that the taxpayer is entitled to the deduction for depletion in the amount of \$7,211.52.

IV

Assignments of Error

The Commissioner avers that in the record and proceedings before The Tax Court of the United States and in the opinion and final decision rendered and entered by The Tax Court of the United States, manifest error occurred [fol. 27] and intervened to the prejudice of the Commissioner who now assigns the following errors and each of them, which he avers occurred in said record, proceedings, opinion, and final decision so rendered and entered by The Tax Court of the United States.

The Tax Court of the United States erred:

(1) In holding and deciding that the taxpayer was entitled to a deduction for percentage depletion in the year 1940 in the amount of \$7,211.52.

(2) In failing to hold and decide that the taxpayer was not entitled to a deduction for percentage depletion in the year 1940 in the amount of \$7,211.52.

(3) In holding and deciding in effect, that the amount of \$26,223.70 received by the taxpayer in the year 1940 was paid to it by reason of its reserved interest in oil in place.

(4) In failing to hold and decide that the amount of \$26,223.70 received by the taxpayer in the year 1940, was not paid to it by reason of its reserved interest in oil in place.

(5) In holding and deciding that the amount of \$26,223.70 received by the taxpayer in the year 1940 represented proceeds from an economic or depletable interest in oil in place.

(6) In failing to hold and decide that the amount of \$26,223.70 received by the taxpayer in the year 1940 did not represent the proceeds from an economic or depletable interest in oil in place.

(7) In ordering and decided that there is a deficiency in income tax of \$930.53 for the calendar year 1940.

(8) In failing to hold and decide that there is a deficiency in income tax of \$2,120.44 for the calendar year 1940.

(9) In that its decision is contrary to law and regulations and is not supported by substantial evidence.

[fol. 28] Wherefore, the Commissioner petitions that the decision of The Tax Court of the United States be reviewed by the United States Circuit Court of Appeals for the Fifth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

(Sgd.) Samuel O. Clark, Jr. CAR.

(Sgd.) Samuel O. Clark, Jr., CAR., Assistant Attorney General; (Signed) J. P. Wenchel, CAR., Chief Counsel, Bureau of Internal Revenue, Of Counsel; Bernard D. Daniels, Special Attorney, Bureau of Internal Revenue.

[fol. 29] *Duly sworn to by Bernard D. Daniels. Jurat omitted in printing.*

[fol. 30] IN UNITED STATES CIRCUIT COURT OF APPEALS

[Title omitted]

NOTICE OF FILING PETITION FOR REVIEW—Filed May 2, 1944

To: Kirby Petroleum Company, Houston, Texas.

You are hereby notified that the Commissioner of Internal Revenue did, on the twenty-first day of April, 1944, filed with the Clerk of Tax Court of the United States at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fifth Circuit, of the decision of The Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the petition for review, as filed, is hereto attached and served upon you.

Dated this twenty-first day of April, 1944.

(Signed) J. P. Wenchel, CAR., Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 25th day of April 1944.

Kirby Petroleum Company, By (Sgd.) George Sawtelle (Title) President, Respondent on Review.

[fol. 31] IN UNITED STATES CIRCUIT COURT OF APPEALS

[Title omitted]

NOTICE OF FILING PETITION FOR REVIEW—Filed May 2, 1944

To: Homer L. Bruce, Esquire, 16th Floor, Niels Esperson Building, Houston, Texas:

You are hereby notified that the Commissioner of Internal Revenue did, on the twenty-first day of April 1944, file with the Clerk of The Tax Court of the United States at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Fifth Circuit, of the decision of The Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the

petition for review, as filed is hereto attached and served upon you.

Dated this twenty-first day of April, 1944.

(Signed) J. P. Wenchel, CAR., Chief Counsel,
Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 25th day of April, 1944.

(Sgd.) Homer L. Bruce, Attorney for Respondent on Review.

[fol. 32] Filed at Hearing.

Div. 15.

THE TAX COURT OF THE UNITED STATES

Docket No. 1509

KIRBY PETROLEUM COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

STIPULATION OF FACTS

The parties to the above numbered and entitled cause agree to the facts set out hereinbelow, subject to the right of either party to object to the materiality or relevancy of any of said facts, and no evidence to controvert any of said facts may be admitted in said cause.

1

Petitioner as lessor and Humble Oil & Refining Company and Marland Oil Company of Texas, as lessees, executed an oil, gas and mineral lease dated September 29, 1927, and attached hereto as Exhibit A is a true and correct copy of said lease. The lease was acknowledged by the officers of the respective parties upon the dates shown in the acknowledgments of said lease and the triplicate original executed copies thereof were delivered to the respective parties shortly after the last acknowledgment.

2

Said parties contemporaneously with the execution and delivery of said lease also executed and delivered an agreement dated September 29, 1927, and attached hereto as Exhibit B is a true and correct copy of said agreement.

[fol. 33]

3

Prior to the execution of said lease and agreement the petitioner had acquired the fee simple title to the two tracts of land described in said lease, except that as to the tract described therein as "First Tract", one Anna Higgins owned $\frac{1}{8}$ of the mineral interest in said tract and this mineral interest was never acquired by petitioner.

4

The lessees commenced the drilling of a well on said First Tract in August, 1932, prior to the termination of the primary term of the lease, and obtained production of oil therefrom and have produced oil therefrom continuously. In March, 1935, petitioner received the first payment of its profits from the operation of said leased premises as provided in the agreement designated as Exhibit B hereto. Petitioner received such payments of profits each year from 1935 and through 1940, and for the year 1940 the amount of such profits received by petitioner was \$26,223.70.

5

In its return for the year 1940 petitioner deducted as an allowance for depletion $27\frac{1}{2}\%$ of said amount of \$26,223.70, or depletion to the extent of \$7,211.52. The Commissioner in his letter of deficiency disallowed this depletion deduction of \$7,211.52. Petitioner does not contest any of the other changes in its income made by the Commissioner in his said deficiency letter.

6

George Sawtelle, if sworn, would testify that as Vice-President of petitioner he executed said lease and agreement set forth as Exhibits A and B and that petitioner would not have executed said lease designated as Exhibit

A unless the lessees had also executed said contemporaneous agreement designated as Exhibit B as a part of the consideration for petitioner's executing said lease, and [fol. 34] the lessees did execute said Exhibit B agreement as part of the consideration for petitioner's executing said lease, and that petitioner also received upon the execution of said lease a cash bonus from the lessees for executing said lease. Said Sawtelle shall be considered as having been sworn in this cause and as having testified as set forth in the foregoing sentence.

7

The return of petitioner for the taxable year 1940 was filed with the Collector of Internal Revenue for the First District of Texas at Austin, Texas.

Homer L. Bruce, Counsel for Petitioner.

(Signed) J. P. Wenchel. J.L.B.

J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent.

[fol. 35] ~ EXHIBIT "A" TO STIPULATION

Oil, Gas and Mineral Lease

This Agreement made this 29th day of September, 1927, between Kirby Petroleum Company, a corporation duly incorporated under the laws of the State of Delaware with its domicile in Harris County, Texas, lessor (whether one or more), and Humble Oil & Refg. Co. and Marland Oil Co., of Texas, lessee. Witnesseth:

1. Lessor in consideration of Ten—and other valuable considerations, Dollars (\$10.00) in hand paid, of the royalties herein provided and of the agreements of lessee herein contained, hereby grants, leases and lets exclusively unto lessee for the purpose of investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals, laying pipe lines, building tanks, power stations, telephone lines and other structures thereon to produce, save, take care of, treat, transport and own said products; and housing its employees the following described land in Chambers County, Texas, to wit:

First Tract: Situated in Chambers County, Texas, and a part of the Henry Griffith League, containing 49.5 acres and described by metes and bounds in a deed dated December 6th, 1923, from Old River Company to Kirby Petroleum Company and designated in said deed as "40th tract."

Second Tract: All of the Dan Jergins Survey No. 13, situated in Chambers County, Texas, and containing 52 acres of land, more or less, and described in a deed from Oil River Company to Kirby Petroleum Company, dated December 6th, 1923, and designated as "24th Tract" in said deed.

2. Subject to the other provisions herein contained, this lease shall be for a term of five years from this date (called "primary term") and as long thereafter as oil, gas or other mineral is produced from said land hereunder.

[36] 3. The royalties to be paid by lessee, are:

(a) on oil, one sixth of that produced and saved from said land, the same to be delivered at the wells or to the credit of lessor in the pipe line to which the wells may be connected; lessee may from time to time purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase; (b) on gas, including casinghead gas and other vaporous or gaseous substances, produced from said land, as follows: In case lessee shall itself use gas in the manufacture of gasoline or other products therefrom 1/6 of 25% of the market value at the plant of the gasoline or other product manufactured therefrom, quantity of product to be ascertained in a manner recognized in the industry; in case lessee shall sell gas at the wells, 1/6 of the amount realized from such sales; and in all other cases when sold or used off the premises, the market price at the well of 1/6 of the gas so sold or used; and (c) on all other mineral mined and marketed, one-sixth either in kind or value at the well or mine at lessee's election, except that on sulphur the royalty shall be fifty cents (50c) per long ton.

4. If operations for drilling are not commenced on said land on or before one year from this date this lease shall then terminate as to both parties unless on or before said anniversary date lessee shall pay or tender to lessor or to the credit of lessor in First National Bank at Hous-

ton, Texas, (which bank and its successors are lessor's agent and shall continue as the depository for all rentals payable hereunder regardless of changes in ownership of said land or the rentals) the sum of Twenty-Five Dollars per acre as above designated, (herein called rental), which shall cover the privilege of deferring commencement of drilling operations for a period of twelve (12) months. In like manner and upon like payments or tenders annually the commencement of drilling operations may be further deferred for successive periods of twelve (12) months each during the primary term. The payment or tender of rentals may be made by the check or draft of lessee mailed or delivered to said bank on or before such [fol. 37] date of payment. If such bank (or any successor bank) shall fail, liquidate or be succeeded by another bank, or for any reason fail or refuse to accept rental, lessee shall not be held in default for failure to make such payment or tender of rental until thirty (30) days after lessor shall deliver to lessee a proper recordable instrument, naming another bank as agent to receive such payments or tenders. The down cash payment is consideration for this lease according to its terms and shall not be allocated as mere rental for a period.

5. If prior to discovery of oil or gas on said land lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or re-working operations within sixty days thereafter or (if it be within the primary term) commences or resumes the payment or tender of rentals on or before the rental paying date next ensuing after the expiration of three months from date of completion of dry hole or cessation of production. If at the expiration of the primary term oil or gas is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than 30 consecutive days, and if they result in the production of oil or gas, so long thereafter as oil or gas is produced from said land. In the event a well or wells producing oil or gas in paying quantities should be brought in on adjacent land and within 150 feet of and draining the leased premises, lessee agrees to drill

such offset wells as a reasonably prudent operator would drill under the same or similar circumstances.

6. Lessee shall have free use of oil, gas, wood and water from said land, except water from lessor's well, for all operations hereunder, and the royalty on oil and gas shall be computed after deducting any so used. Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by lessee on said land, including the right to draw and remove all casing. When required by lessor, lessee will [fol. 38] bury all pipe lines below ordinary plow depth, and no well shall be drilled within two hundred feet of any residence or barn now on said land without lessor's consent. Lessor shall have the privilege at his risk and expense of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon out of any surplus gas not needed for operations hereunder.

7. The rights of either party hereunder may be assigned in whole or in part and the provisions hereof shall extend to the heirs, successors and assigns, but no change or divisions in ownership of the land, rentals, or royalties however accomplished shall operate to enlarge the obligations or diminish the rights of lessee. No sale or assignment by lessor shall be binding on lessee until lessee shall be furnished with a certified copy of recorded instrument evidencing same. In event of assignment of this lease as to a segregated portion of said land the rentals payable hereunder shall be apportionable as between the several leasehold owners ratably according to the surface area of each, and default in rental payment by one shall not affect the rights of other leasehold owners hereunder. If six or more parties become entitled to royalty hereunder, lessee may withhold payment thereof unless and until furnished with a recordable instrument executed by all such parties designating an agent to receive payment for all.

8. All obligations of lessee hereunder, both express and implied, are to be understood as covenants and not conditions or limitations; and, save as hereinafter expressly provided, the breach of same shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby nor be grounds for a cancellation hereof, in whole or in part. If the obliga-

tion for reasonable development should require the drilling of a well or wells, lessee shall have 90 days after final judicial ascertainment of the existence of such obligation by the court of last resort hearing such matter within which to begin the drilling of a well, and the only penalty for failure to do so shall be the termination of this lease save as to 10 acres for each well being worked on and/or [fol. 39] being drilled and/or producing oil or gas to be selected by lessee so that each 10-acre tract will embrace one such well.

9. Lessor hereby warrants and agrees to defend the title to said land and agrees that lessee at its option may discharge any tax, mortgage or other lien upon said land and in event lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and royalties accruing hereunder toward satisfying same. Without impairment of lessee's rights under the warranty in event of failure of title, it is agreed that if lessor owns an interest in said land less than the entire fee simple estate, then the royalties and rentals to be paid lessor shall be reduced proportionately.

In Witness Whereof, this instrument is executed on the date first above written, in triplicate originals.

Kirby Petroleum Company, by George Sawtelle,
Vice-President.

Attest: C. W. Craig, Secretary. (Seal.)

Humble Oil & Refining Company, by F. P. Sterling,
Vice-President.

Attest: Jas. Strate, Asst. Secretary. (Seal.)

Marland Oil Company of Texas, by W. A. Moncrief,
Vice-President.

Attest: Wm. Preston, Secretary. (Seal.)

[fol. 40] THE STATE OF TEXAS,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared George Sawtelle, Vice-President of the Kirby Petroleum Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capac-

ity therein stated and as the act and deed of Kirby Petroleum Company.

Given Under My Hand and seal of office, this the 5th day of October, A. D. 1927. Alice Newcomer, Notary Public in and for Harris County, Texas. (Seal.)

THE STATE OF TEXAS,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared F. P. Sterling, Vice-President of Humble Oil & Refining Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of said corporation.

Given Under My Hand and seal of office, this 20th day of October, A. D. 1927. James S. Clarke, Notary Public in and for Harris County, Texas. (Seal.)

[fol. 41] THE STATE OF TEXAS,
County of Tarrant:

Before Me, the undersigned authority, on this day personally appeared W. A. Moncrief, Vice-President of Marland Oil Company of Texas, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed in the capacity therein stated, and as the act and deed of said Marland Oil Company of Texas.

Given Under My Hand and seal of office, this the 17th day of October, A. D. 1927. Grace Moore, Notary Public in and for Harris County, Texas. (Seal.)

[fol. 42] EXHIBIT "B" TO STIPULATION

THE STATE OF TEXAS,
County of Harris:

This Agreement This Day Made And Entered Into between Humble Oil & Refining Company and Marland Oil

Company of Texas, hereinafter called First Party (whether one or more), and Kirby Petroleum Company, hereinafter called Second Party, all of said parties being private corporations duly authorized to do business in the State of Texas, Witnesseth:

Second Party, as lessor has this day executed and delivered to the First Party, as lessee, an oil, gas and mineral lease covering two tracts of land in Liberty and Chambers Counties, Texas, described as follows, to-wit:

First Tract: Situated in Chambers County, Texas, and a part of the Henry Griffith League, containing 49.5 acres and describes by metes and bounds in a deed dated December 6th, 1923 from Old River Company to Kirby Petroleum Company and designated in said deed as "40th tract".

Second Tract: All of the Dan Jergins Survey No. 13, situated in Chambers County, Texas, and containing 52 acres of land, more or less, and described in a deed from Old River Company to Kirby Petroleum Company dated December 6th, 1923, and designated as "24th Tract" in said deed.

The parties to said lease have agreed that Second Party shall be entitled to receive twenty percent (20%) of the net money profits derived by First Party from operations under said lease, said twenty percent (20%) net money profits interest being specifically described and *and* defined and payable as is hereinafter provided.

[fol. 43] Now, Therefore, in consideration of the premises and Ten Dollars (\$10.00) in hand paid by Second Party to First Party, the receipt of which is acknowledged, and the mutual covenants and obligations of the parties hereto, it is hereby agreed as follows, to-wit:

I

Second Party, subject to the terms and provisions hereof and in the manner herein provided, shall be entitled to receive twenty percent (20%) of the net money profits realized by First Party from its operations under and by virtue of the lease referred to above. The net money profits in which Second Party shall participate under the terms hereof, shall be calculated and determined and be payable as hereinafter provided.

II

First Party shall have exclusive charge, control and supervision of all operations of every kind to be conducted on said land for the development, production, treating, handling and marketing of oil, gas and other minerals therefrom, as well as the payment of rentals, royalties, taxes and other charges which may arise or become due.

III.

First Party shall charge to the account covering the lease referred to above, all costs and expenses incurred in connection with the operation of said premises including all labor directly employed in connection with the operation of said property; all materials, supplies and equipment, including rentals on all trucks, drilling rigs, tools, pipes, etc., let for use in connection with the operation of said property, at the current prevailing rental charge by First Party to its own leases, said trucks, rigs and other rented property to be returned by said accounts in the same condition as when received, reasonable wear and tear excepted; miscellaneous field expenses apportionable in connection with operations on the above described property; all charges for fuel, water, power, teaming and other [fol. 44] services incurred in connection with the operation of said premises, such charges to be made only for actual services rendered and at the current customary rates prevailing in the field; losses, damages or liabilities sustained or incurred in connection with the operation of said property; expenses of marketing the products; royalties and other items payable to other than lessor under the terms of the lease covering said land; gross production, ad valorem and other taxes and governmental charges, except Federal Income Taxes; workmen's compensation, liability, fire, wind, tornado and other insurance premiums paid.

No home office, or other overhead charge shall be made to the joint account in connection with the operation of said premises, but, to cover bookkeeping, accounting and office expenses generally, a charge of Twenty-five Dollars (\$25.00) per well per month shall be made to joint account, and to cover supervision and all other general and division overhead expenses, a charge of Twenty-five Dollars (\$25.00) per month on each producing well and Fifty Dollars (\$50.00) per month on each drilling well shall also

be made to joint account. Second-hand material and equipment supplied to the premises shall be charged to the account at their fair value, not to exceed (except as to small pipe fittings) seventy-five percent (75%) of the current market price of new materials and equipment of like kind at the time of transfer. All materials, supplies and equipment furnished from First Party's warehouse shall be charged to the account at cost to First Party, including freight, plus five percent (5%) on pipe and tubular goods and ten percent (10%) on other materials and supplies, as warehouse and handling charges. Used materials removed from the premises by First Party, whether upon abandonment or currently in course of operation, shall be credited to the account at the current prevailing discounts used by First Party upon removal of such materials from its own properties. Any material charged against the lease but not used by the lease and removed from the premises by First Party shall be credited to the account at its fair value.

[fol. 45] Should the title of the lessors in the lease referred to above fail in whole or in part, and First Party become obligated or required to pay damages by reason of its operations under said lease, Second Party agrees to reimburse First Party within Fifteen (15) days after demand made by First Party to the extent of Twenty percent (20%) of such damages, provided, however, Second Party shall not be required to pay First Party an amount in excess of the amounts which had theretofore been received by Second Party, but any such excess shall be charged as a loss against the returns from said tracts of land for the first and successive months until First Party has been fully indemnified. Any expenses or costs incurred by First Party in defending any suit involving the title or the rights of First Party under the lease referred to above, shall be charged to the account covering the lease as a part of the costs of operations.

IV

First Party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, and in which the parties hereto may be interested. Upon the sale of any of such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales. If it desires to

do so, First Party may take over all or any part of such production itself for its own use and benefit, and in such event, the accounts (covering the lease referred to above) shall be credited on the following basis, to-wit:

(a). On Oil: The current price per barrel on the date of respective runs to pipe line, or if not run to pipe line, then on date of respective runs to storage for account of First Party, posted by First Party for the field where the production is located.

(b). For gas of any kind: The market value at the well.

(c). Other Minerals: The market value at the well or mine.

[fol. 46]

V

The total net profits (or total net loss as the case may be) shall be determined by deducting the total charges made against the lease as authorized herein from the total credits allowed the lease as authorized herein.

Second Party shall participate in the profits derived from the sale of the oil and gas and other mineral production of the lease embraced in this agreement only after all charges and debits and costs of producing profits shall have been paid and provided for. It is expressly agreed that First Party shall have the right to carry forward any loss from operations as a charge against the net profit account for the next and succeeding months until such loss has been wiped out and paid.

VI

First Party shall keep an accurate record of all accounts hereunder showing the costs and expenses incurred and charges made and all authorized credits and returns made and received, which record shall be available at all reasonable times for the examination and inspection of First Party and his or its duly authorized representatives. Second Party shall also have access at all reasonable times to the well and production records and reports relating to said premises. Within one (1) month after the close of each calendar month First Party shall furnish to Second Party a statement of authorized expenses incurred and charges made and authorized credits made during

such calendar month. Any exceptions to the statement as rendered by First Party must be made by Second Party within sixty (60) days from the receipt of same and if no exception is made within such time, then such statement shall be considered as correct.

[fol. 47] Within one (1) month after the close of each calendar month Second Party shall be paid its twenty percent (20%) of the net money profits derived from the operation of the said lease as calculated and determined under the terms hereof.

VII

In case of disagreement as to any matter relating to the correctness of the accounts hereunder which can not be settled amicably, then, upon five days' written notice given by one party to the other, such matter in disagreement shall be submitted to a board of three arbitrators. Each party hereto agrees to appoint one arbitrator within ten (10) days after such notice is given; the third arbitrator shall be chosen promptly by the two so appointed; all three arbitrators shall be disinterested practical oil operators. Pending a decision of such board of arbitrators, the parties hereto shall remain bound by the express terms hereof. Any and all decisions rendered by a majority of said board of arbitrators shall be final and binding upon the parties hereto, and adjustments shall be made in conformity with their award.

VIII

Any written notices required or permitted to be given hereunder may be made or given to First Party as follows: To Humble Oil & Refining Company at its office in Houston, Texas, and to Marland Oil Company of Texas at its office in Fort Worth, Texas, and may be given to Second Party at Houston, Texas. The statements and payments provided for in paragraph VI hereof, may be made to Second Party at Houston, Texas.

IX

This contract shall be binding upon the parties hereto and their respective successors in interest.

[fol. 48] In Testimony Whereof, witness the hands and seals of the parties hereof, in triplicate originals, this the 29th day of September, A. D. 1927.

Humble Oil & Refining Company, by F. P. Sterling,
Vice-President. (Seal.)

Attest: Jas. Strate, Asst. Secretary.

Marland Oil Company of Texas, by W. A. Moncrief,
Vice-President. First Party. (Seal.)

Attest: Wm. Preston, Secretary.

Kirby Petroleum Company, by George Sawtelle,
Vice-President. Second party. (Seal.)

Attest: C. W. Craig, Secretary.

[fol. 49] THE STATE OF TEXAS,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared F. P. Sterling, Vice-President of Humble Oil and Refining Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of said Corporation.

Given Under My Hand and seal of office, this the 20th day of October, A. D. 1927.

James S. Clark, Notary Public in and for Harris
County, Texas. (Seal.)

THE STATE OF TEXAS,
County of Tarrant:

Before Me, the undersigned authority, on this day personally appeared W. A. Moncrief, Vice-President of Marland Oil Company of Texas, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of Marland Oil Company of Texas.

Given Under My Hand and seal of office, this the 17th day of October, A. D. 1927.

Grace Moore, Notary Public in and for Tarrant County, Texas. (Seal.)

[fol. 50] THE STATE OF TEXAS,
County of Harris:

Before Me, the undersigned authority, on this day personally appeared George Sawtelle, Vice-President of Kirby Petroleum Company, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed, in the capacity therein stated and as the act and deed of Kirby Petroleum Company.

Given Under My Hand and seal of office, this the 5th day of October, A. D. 1927.

Alice Newcomer, Notary Public in and for Harris County, Texas. (Seal.)

Finis

[fol. 51] IN THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE FIFTH CIRCUIT

[Title omitted]

PRÆCIPE FOR RECORD—Filed June 9, 1944

To the Clerk of The Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, copies duly certified as correct, of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Fifth Circuit, heretofore filed by the Commissioner of Internal Revenue:

- (1) Docket entries of the proceedings before The Tax Court of the United States.
- (2) Pleadings before The Tax Court of the United States:

(a) Petition filed May 3, 1943 (with Exhibit, deficiency letter, attached).

(a) Answer filed June 4, 1943.

(3) Opinion of The Tax Court of the United States reported in 2 T. C. 1258.

(4) Decision of The Tax Court of the United States entered February 5, 1944.

(5) Petition for review and assignments of error, together with proof of service of Notice of Filing Petition [fol. 52] for Review and Assignments of Error.

(6) Agreed Stipulation of Facts including attached Exhibits "A" and "B."

(7) This Praecept for Record.

The said Transcript to be prepared, certified and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Fifth Circuit.

(Sgd.) Samuel O. Clark, Jr., C. A. R., Assistant Attorney General; (Signed) J. P. Wenchel, C. A. R., Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Service of a copy of the within Praecept for Record on review is hereby admitted this — day of June, 1944.

Agreed to:

Homer L. Bruce, Attorney, 16th Floor, Niels Esperson Building, Houston, Texas, Attorney for Respondent on Review.

[fol. 53] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 54] That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:—

ARGUMENT AND SUBMISSION

Extract from the Minutes of January 31, 1945

No. 11065

COMMISSIONER OF INTERNAL REVENUE,

versus

KIRBY PETROLEUM COMPANY

On this day this cause was called, and, after argument by I. Henry Kutz, Esq., Special Assistant to the Attorney General, for petitioner, and Homer L. Bruce, Esq., for respondent, was submitted to the Court.

[fol. 55] OPINION OF THE COURT AND DISSENTING OPINION
BY HUTCHESON, CIRCUIT JUDGE—Filed March 5, 1945

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE
FIFTH CIRCUIT

No. 11065

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

versus

KIRBY PETROLEUM COMPANY, Respondent

Petition for Review of Decision of the Tax Court of the
United States (District of Texas)

(March 5, 1945)

Before Hutcheson, Holmes, and McCord, Circuit Judges
HOLMES, Circuit Judge:

This appeal involves income taxes of the Kirby Petroleum Company for the year 1940. The question presented for review is whether the taxpayer is entitled, under Sec-

tions 23(m) and 114(b)(3) of the Internal Revenue Code, [fol. 56] to a depletion deduction of $27\frac{1}{2}$ per cent on the amount received by it as its share of the net profits realized by its lessees from operations under an oil and gas lease.

The taxpayer owned a tract of land in Texas upon which a $\frac{1}{8}$ mineral interest had been retained by a former owner. It leased the tract to an oil company for exploration and production, reserving a $\frac{1}{6}$ royalty in the minerals (which included the $\frac{1}{8}$ held by the former owner) and receiving a bonus. It was stipulated that all obligations of the lessees were to be understood as covenants and not as conditions or limitations. Contemporaneously with the execution of the lease, the parties executed an agreement under which the taxpayer was to receive 20 per cent of the net profits realized by the lessees from their operations under said lease.

During the year 1940, the taxpayer received \$26,223.70 as its share of the net profits. In its income tax return for that year, it deducted $27\frac{1}{2}$ per cent depletion on this amount. There was no dispute as to the depletion allowances on the cash bonus and royalty payments. The Commissioner allowed these items, but disallowed the depletion deduction on the amount of the net profits. The Tax Court ruled that depletion on the profits should have been allowed since the lessor had an economic interest in the oil in place.

Gross income from the property, as used in Section 114 (b)(3), means gross income from the oil and gas.¹ The allowance is to the recipients of this gross income by reason of their capital investment in the minerals.² The allowance of percentage depletion is made only to the persons who would be entitled to claim cost depletion on account of their ownership of a depletable capital asset, the [fol. 57] fundamental theory of the allowance not having been altered by the provisions for percentage depletion.³ The existence of a capital interest in the minerals is the

¹ Helvering v. Mountain Producers Corp., 303 U. S. 376, 382.

² Helvering v. Bankline Oil Co., 303 U. S. 362, 367.

³ United States v. Dakota-Montana Oil Co., 288 U. S. 459, 467.

sine qua non for claiming the deduction for depletion; otherwise the taxpayer has no capital investment that has suffered depletion, and is not entitled to the statutory allowance.⁴

The percentage depletion cannot exceed $27\frac{1}{2}$ per cent of the gross value of the captured minerals. The nature of the interest in the deposit does not turn upon the form of the conveyance; but upon the particular consequences of the provisions for payments.⁵ It is immaterial that the transfers here were accomplished by means of a lease; what is material is that the right of the taxpayer to share in the net profits was not derived from the retention of any depletable interest in the oil and gas in place.

Prior to the execution of the lease and the agreement here involved, the taxpayer (with exception of the $\frac{1}{8}$ interest mentioned) had the entire capital investment in the underlying oil and gas. To the extent of the cash bonus and the right to royalty payments, it retained a proportionate economic interest in the oil and gas in place, and to that extent the lessees did not acquire a depletable interest,⁶ but to the extent that the taxpayer granted exploration rights and an interest in the minerals in place to producers in exchange for their personal covenant to pay a share of their net profits, there was a conveyance of the taxpayer's interest in a wasting capital asset, and the producers acquired a proportionate depletable interest in the oil and gas conveyed.⁷ By surrendering a partial [fol. 58] interest in the oil and gas produced from the property, the taxpayer converted a portion of its economic interest into a mere chose in action or economic advantage.⁸ Thus in *Helvering v. O'Donnell*, 303 U. S. 370, it was held that the taxpayer who had only a contractual

⁴ *Helvering v. Bankline Oil Co.*, *supra*, p. 368.

⁵ *Anderson v. Helvering*, 310 U. S. 404, 411.

⁶ *Palmer v. Bender*, 287 U. S. 551, 558; *Murphy Oil Co. v. Burnet*, 287 U. S. 299; *Burnet v. Harmel*, 287 U. S. 103; *Bankers Coal Co. v. Burnet*, 287 U. S. 308; *Anderson v. Helvering*, *supra*, p. 408.

⁷ *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372; *Anderson v. Helvering*, *supra*.

⁸ *Helvering v. Bankline Oil Co.*, *supra*, pp. 366, 367.

right to share in the net profits did not have a depletable interest.

In *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372, the reservation of the right to share in net profits by the former owner of the mineral deposits was ruled not to constitute a retention of a capital investment in the oil in place. In *Anderson v. Helvering*, 310 U. S. 404, the reservation of the right to share in net profits was held not to entitle the holder of such interest to a depletion allowance even though continued production was essential to the realization of such profits. There are good reasons for the rule; the depletion deduction is granted in recognition of the fact that the person having the requisite economic interest received a partial return of his capital investment when production took place.⁹

A taxpayer who leases solely for net profits no longer has a direct interest in the production of mineral deposits; his interest is in the ability of the operators to earn profits. It is true that there would be no net profits if there were no production; but since production could take place without there being any net profits, the taxpayer's income accrues after, not at the time of, the extraction of the oil and gas from the deposits. These principles have been given concrete application by this court.¹⁰ The single depletion allowance is subject to apportionment among the parties in accordance with their economic interests.¹¹ Therefore, the retention of a partial interest in production necessarily results in the retention of only a proportionate capital investment in the oil and gas in place.

The instant case cannot be distinguished from the *O'Donnell*, *Anderson*, and *Elbe Oil Company* cases on the ground that in those the right to share in the net profits was not accompanied by an interest in the minerals. Here the retention of an oil royalty in addition to a share of the net profits operated to reserve an interest in the oil

⁹ *Helvering v. Bankline Oil Co.*, supra, pp. 366, 367.

¹⁰ *Blankenship v. United States*, 95 F. (2) 507; *Sneed v. Commissioner*, 119 F. (2) 767, 770; *Commissioner v. Caldwell Oil Corp.*, 141 F. (2) 559, 561; *Quintana Petroleum Co. v. Commissioner*, 143 F. (2) 588.

¹¹ *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, 321.

in place, but it was a partial interest that was not enhanced by the personal covenant to pay a percentage of net profits. Here at the instant of production, $\frac{1}{8}$ of the oil belonged to the former owner, $\frac{1}{24}$ (plus an amount sufficient to pay the cash bonus) was owned by the taxpayer, and the balance belonged to the lessees. The value of each proportionate share was the gross income of each, as to which amount each was entitled to take a $27\frac{1}{2}$ per cent deduction for depletion. As the court said in *Thomas v. Perkins*, 301 U. S. 655, 661, construing its opinion in *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, "Our opinion shows that the phrase 'income from the property' means income from oil and gas only; that where the lessee turns over royalty oil in kind to the lessor, the amount retained by the lessee is the basis for his computation of depletion and the royalty oil is the basis for that allowable to the lessor."

The respondent claims, and the Tax Court held, that its gross income from the property was "clearly the proceeds from the $\frac{1}{6}$ [should be $\frac{1}{24}$] royalty interest which petitioner retained in the lease and the 20 per cent annual profits which it received from the operator of the lease under the contemporaneous agreement amounting in 1940 to \$26,223.70." In other words, the claim is that a net profit is gross income if paid by the lessee to the lessor of oil property. This would not be so, it is admitted, if the [fol. 60] lessor had not reserved in the lease a royalty interest that entitles it to some percentage depletion. The argument is that this reservation converts a net profit into a bonus and distinguishes this case from the *O'Donnell* and similar cases above cited; but there is no difference in the controlling legal principle that underlies them all. The payment of net profits to the lessor is not the payment in kind of royalty oil or its equivalent.

A bonus is subject to percentage depletion upon the theory that it is an advance royalty; but net profits are not paid in advance, and cannot be paid until they are earned and ascertained. Gross income, under the statute, is exclusive of any rents or royalties paid or incurred by the taxpayer. If, therefore, net profits are held to be rents or royalties within the meaning of Section 114(b)(3), the depletable gross income thereunder cannot be ascertained until we determine the amount of the net income. Under the present state of the law, the depletion allowance of

27½ per cent is granted upon the gross income from every barrel of oil captured, which allowance is apportioned *pro rata* among those who own the oil itself.¹² Gross income of the royalty owners is the full amount of their royalty, and gross income of the lease operator is the total production less the royalties. Under the terms of the lease here involved, 5/6 of the oil and gas was owned by the producers, 1/8 by the former owner, 1/24 by the taxpayer; and the depletion upon gross production was, and should have been, apportioned accordingly.

If net profits, which cannot be computed or paid until they are earned, are rents and royalties within the meaning of Section 114(b)(3), the depletion allowances on the working interest cannot be ascertained until the amount [fol. 61] of net income is determined. This poses an abstruse problem instead of the rule of thumb that the arbitrary percentage-depletion allowance was intended to be.¹³ To extend the allowance to include 27½ per cent of the net profits paid to the lessor by the lessees "would give rise to problems of considerable perplexity and would create administrative difficulties which it was intended to overcome by laying down a simple rule which could be easily applied."¹⁴

In addition, it would be a departure from the theory upon which bonus payments are depletable, since no economic interest in the oil in place was reserved by the lessor to represent the contingency of net profits that might be earned. On the contrary, the lessor accepted the personal covenant of the lessees to pay whatever amount of net profits became due by the lessees. This entailed upon the lessor the financial risk of the lessees' personal ability to earn profits and to account for them. For these reasons we conclude that the doctrine of advance royalty payments cannot be extended to net profits.

The decision of the Tax Court is reversed, and the cause remanded for further proceedings not inconsistent with this opinion.

¹² *Helvering v. Twin Bell Syndicate*, 293 U. S. 312; *Thomas v. Perkins*, 301 U. S. 655.

¹³ *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, 321; *Helvering v. Producers Corporation*, 303 U. S. 376, 381.

¹⁴ *Helvering v. Producers Corporation*, *supra*.

HUTCHESON, Circuit Judge, Dissenting:

Believing that the Tax Court is clearly right and that the opinion of the majority completely misconceives both the facts and the law, I think it well, in order to point this out, to fully state the facts which control the decision of this case and restate the controlling principles.

[fol. 62] Taxpayer, the fee owner of two tracts of oil bearing land, leased them in 1927 for a cash bonus, an oil royalty of one-sixth, and oil payments of 20 percent to be paid out of the net profits from production. Oil was discovered in 1932, and in 1935, 1936, 1937, 1938, 1939 and 1940, taxpayer received out of production its royalty and also payments on account of the 20 percent it had reserved. Of the opinion that all of the payments made to it out of production were a return of its capital interest in the oil in place, taxpayer, on the authority of *W. S. Green*, 26 B. T. A., 1017, a precisely similar case, claimed, and for 1935 through 1939 was allowed, depletion of them all. For 1940, the tax year in question here, the commissioner allowed the depletion on the one-sixth royalty, but denied it on the oil payments on the ground that these were not payments out of an interest in oil reserved by taxpayer but were mere cash payments on an outright sale of the minerals it owned.

The Tax Court took a different view. It found,¹ on a record which fully supports the finding, that, by the leasing arrangements, lessor retained an economic interest in the minerals in place, and provided for its return out of production, in part through the one-sixth royalty, and in part through the 20 per cent payments. It held, on considerations which I think cannot be gainsaid, and on an analysis of the authorities which I find unanswerable, that these payments were not cash payments agreed upon as the purchase price for an outright sale, but oil payments out of production of oil in which taxpayer had, to the extent of royalty and payments, retained an economic interest. It rejected the commissioner's disallowance and ordered the deficiencies redetermined accordingly.

The commissioner, pointing with unwavering finger at the words, "net profits" realized by lessees from their [fol. 63] operation of the lease, used by the parties as the measure of the payments out of production, is here insisting

¹ 2 T. C. 1258.

that the cases he cites ² require a reversal of the Tax Court's ruling.

Taxpayer is here insisting that this is just another of the all too many cases in which a too intense preoccupation by the commissioner with words as formulas, here "net profits", coupled with a complete disregard of the controlling facts existing and found by the Tax Court as to what the parties intended to do and did do, has led the commissioner astray. He points out that the cited cases, except *Commissioner v. Caldwell*, 141 F. (2) 559, which taxpayer insists supports it and not the commissioner, dealt with situations in which it was clear that the taxpayer, reserving no economic interest in the minerals in place, but, by outright sale, parting with all of them, had made provisions, sometimes in one way and sometimes in another, merely for payments in cash of the consideration for the sale. He insists that the situation here is quite different in fact, and the controlling cases are: *Thomas v. Perkins*, 301 U. S. 655; ³ *Spalding v. U. S.*, 97 F. (2) 697; *Commissioner v. Felix*, 144 F. (2) 276; and *Commissioner v. Caldwell*, 141 F. (2) 559, where, as here, there was no outright sale but merely a leasing of the property for oil development with a provision for return to the lessor of the interest it had reserved, in part through a bonus, in part through a fixed royalty, and in part through fixed payments out of the production of oil.

I think it clear that the Tax Court was right. The most cursory examination of the contracts which effected the [fol. 64] leasing arrangement ⁴ discloses that the words "net

² *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe*, 303 U. S. 372; *Anderson v. Helvering*, 310 U. S. 404; *Blankenship v. U. S.*, 95 F. (2) 507; *Quintana Petroleum Co. v. Comm.*, 143 F. (2) 588; and *Comm. v. Caldwell*, 141 F. (2) 559.

³ Cf. the thoughtful analysis and application of that case in *Anderson v. Helvering*, 310 U. S. at pp. 409-13.

⁴ These arrangements provided for the royalty and made the ordinary provisions carried in oil lease contracts. In addition, after providing that the lessees should have exclusive charge of all operations to be conducted on the land as well as the payment of rentals, royalties, taxes and other charges which may become due, the contract went into most

profits" were used merely as a shorthand way of saying that Kirby's part of the gross production was to be 20 percent, less, however, 20 percent of the charges and expenses of operation as provided in the agreement. Thus, in fact and in legal effect, the agreement was the same as if it had in terms provided that lessor retained, and was to have, 20 percent of the gross profits from production, subject, however, to the payment of 20 percent of the specified expenses, and the 20 percent payment it received constituted, under *Helvering v. Producers*, 303 U. S. 382, the "gross income" on which its depletion must be taken. Cf. *Commissioner v. Felix*, 144 F. (2) 276.

That the parties intended by the leasing contracts, not an outright sale of the properties but to provide for the retention by taxpayer of an interest in the oil in place is suggested by even the most superficial view of the contracts and the circumstances attending their making and carrying out. The assembling and analysis of the significant facts found by the Tax Court leaves me in no doubt that

careful detail as to the costs and expenses which were to be charged to the joint account. Providing "no home office or other overhead charge shall be made to the joint account in connection with the operation of premises", it provided: for a fixed bookkeeping and expense charge; that material should be charged at cost; and otherwise made it clear that though lessee was to be the operator of the premises and was to make payments to lessor equivalent to 20 percent of the net profits therefrom, the operation was for joint account.

Clause IV provided: "First Party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, *and in which the parties hereto may be interested*", (emphasis supplied). "Upon the sale of any such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales. * * *".

Clause V provided: "The total net profits (or total net loss as the case may be) shall be determined by deducting the total charges made against the lease as authorized herein from the total credits allowed the lease as authorized herein. Second Party shall participate in the profits derived from the sale of the oil and gas and other mineral production of

taxpayer is entitled to the depletion. Taxpayer was the owner in fee of the property, and it did not sell it outright for a price to be paid in cash, but, on the contrary, leased it for a royalty and a bonus to be paid, part in cash and part from future production. It neither received nor contracted to receive any cash as the purchase price, but only as bonus, that is as advanced royalty, as royalty and as oil payments. It carefully guarded the ascertainment of the net profits through the receipt of which it was to recover part of its reserved capital by specifying what charges should be made and how they were to be made. To remove from any doubt the fact that taxpayer had retained an interest in the property, the contract, though providing that first party should have exclusive charge of operations as well as the payment of rentals, royalties and other charges, in Clause IV declared: "First party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, and in which the parties

the lease embraced in this agreement only after *all charges and debits and costs* of producing profits shall have been paid and provided for. It is expressly agreed that First Party shall have the right to carry forward any loss from operations as a charge against the net profit account for the next and succeeding months until such loss has been wiped out and paid." (Emphasis supplied.)

Clause VI provided that First Party should keep an accurate record of all accounts, which record should be available at all times for examination and inspection by second party, and "Second Party shall also have access at all reasonable times to the well and production records and reports relating to said premises." First party was required within one month after the close of each calendar month to furnish Second Party with statement of authorized expenses incurred and charges made and authorized credits made. It provided finally that within one month after the close of each calendar month Second Party shall be paid its 20 percent of the net money profits derived from the operation of the lease as calculated and determined under the terms hereof. ○

Clause IX provided: "*This Contract Shall Be Binding upon the Parties Hereto and Their Respective Successors in Interest*". (Emphasis supplied.)

hereto may be interested". Clause V provided: "Second Party shall participate in the profits derived from the sale of the oil and gas and other mineral production of the lease only after all charges and debits and costs of producing profits shall have been paid and provided for". Finally, the Ninth clause, providing that the contract shall be binding [fol. 66] on the parties and their successors, makes it entirely clear that it did not impose a mere personal obligation, but, on the contrary, fixed a charge upon the property to protect the interest, taxpayer had retained. If, as the commissioner claims, the lessor had no interest in the premises or in the production, what was there to bind the successors to? If the contract was merely a personal agreement to pay money, what was the office of the clause?

It will serve no useful purpose for me to analyze each of the cases cited by the commissioner. The Tax Court has sufficiently distinguished them. It is sufficient to say that some of them are not depletion cases at all. In most the issue was who owned the production, that is to whom it was taxable as ordinary income. The commissioner does not contend that the 20 percent payments are taxable as ordinary income to the lessees and not to the taxpayer, as was successfully contended in some of the cases commissioner cites, and as would be the case here if the commissioner is right. Quite to the contrary, he accepts them as ordinary income as they were returned by Kirby, and insists on taxing them as such. As *Anderson v. Helvering*⁵ makes clear, if Kirby is not entitled to depletion on these payments, it is because they are the income of the operators and taxable to them. Pointing out that it is the substance of what has occurred which determines who is the owner of, and there-

⁵ "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest. *Helvering v. Bankline Oil Co.*, 303 U. S. 362, 367; *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe Oil Co.*, 303 U. S. 372; *Thomas v. Perkins*, 301 U. S. 655, 661, 663; *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, 321; *Palmer vs. Bender*, 287 U. S. 551. Cf. *Helvering v. Clifford*, 309 U. S. 331."

fore the payer of taxes on, income from oil production, it makes clear that what is significant in determining this is whether a person, who has owned land and has dealt with [fol. 67] reference to the minerals under it, has sold the minerals outright and is looking to the production, if at all, merely as a measure of the cash payments for the sale, or whether he has intended to reserve, and has reserved, in any form, an interest in the minerals and is looking, to recover it, to the production. Discussing and analyzing the different situations in which this question has been presented to the courts, the Court makes it clear that just as royalties are, cash bonuses, *Burnet v. Harmel*, 287 U. S. 103, and oil payments, *Thomas v. Perkins*, 301 U. S. 655, are entitled to depletion. Declaring that the decision in *Thomas v. Perkins* did not turn upon the particular instrument involved nor upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type, it pointedly reaffirmed the depletable of oil payments. Saying that the circumstances urged by the commissioner, that the provision for oil payments in the case under decision was not phrased in terms of a reservation and that the payments were to be in cash rather than directly in oil, are without significance in determining the issues presented for decision, the court denied depletion there because, and only because, the claimant there was not entirely dependent for the deferred payments upon the production of oil, but had a right to look also to sales of the fee.

Helvering v. Anderson makes it plain that there is no difficulty about the principle to be applied. The difficulty comes only in its attempted application. All agree that an outright sale of oil without reservation of an economic interest does not entitle the seller to depletion on partial payments of the purchase price. No case holds differently. No one really contends differently. If what was done here was in fact not to reserve an interest in the production, the commissioner is right, while if what was done was, as the Tax Court has found and held, to reserve such an interest, taxpayer is right. The Tax Court has found as a fact that [fol. 68], by their agreements for leasing the parties arranged that lessor was to have out of the production a cash bonus, a royalty, and additional payments out of 20 per cent of the net profits. *Helvering v. Anderson* makes it plain, too, that the Tax Court was right in holding, as it

did in *Commissioner v. Felix, supra*, that a provision for 50 percent of the net profits, and, as it did in *Commissioner v. Caldwell, supra*, that a provision for all of the net profits until certain amounts were paid back, entitled the owner of the oil payments to depletion, and that the courts were right in those cases in affirming the Tax Court. It also makes it plain that the Tax Court was right in allowing depletion here, and that its judgment should be Affirmed.

[fol. 69]

JUDGMENT

Extract from the Minutes of March 5th, 1945

No. 11065

COMMISSIONER OF INTERNAL REVENUE,

versus

KIRBY PETROLEUM COMPANY

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of the Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that the decision of the said Tax Court of the United States in this cause be, and the same is hereby, reversed; and that this cause be, and it is hereby, remanded to the said Tax Court of the United States for further proceedings not inconsistent with the opinion of this Court.

"Hutcheson, Circuit Judge, dissents."

[fol. 70] Clerk's Certificate to foregoing transcript omitted in printing.

(7374)

[fol. 71] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI²—Filed May 21, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Endorsed on Cover: Enter Homer L. Bruce. File No. 49592. U. S. Circuit Court of Appeals, Fifth Circuit. Term No. 56. Kirby Petroleum Company, Petitioner, vs. Commissioner of Internal Revenue. Petition for writ of certiorari and exhibit thereto. Filed April 9, 1945. Term No. 56, O. T. 1945.

(9441)